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THE THEORY OF DEBIT AND CREDIT IN ACCOUNTING

ROBERT GARDNER McCLUNG

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by
Robert Gardner McClung

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Preface

Every student of accounting experiences difficulty in seeing any principle on which impersonal accounts are debited and credited. At the outset, he wonders why "Cash" should be debited when money is received, and credited when money is paid out; and, as the other impersonal accounts are taken up, his difficulty increases. Various explanations for the debit and credit of impersonal accounts have been given. None of them ever seemed to the writer satisfactory. After long and careful consideration of the subject, he submits the explanation contained in the following pages as the correct one.

R. G. M.

Boston, Aug. 6, 1913.

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THE THEORY OF DEBIT AND CREDIT IN ACCOUNTING

THERE cannot be a debtor unless there is a creditor, and there cannot be a creditor unless there is a debtor. The terms are correlative; the one implies the other. An impersonal thing cannot be either a debtor or a creditor, except by a fiction. A thing, however, may stand for a person who is a debtor or a creditor. In other words, it may represent him.

A. deposits one thousand dollars with me. He is a creditor; I am a debtor. I open an account in his name and credit him one thousand dollars. To complete the record, I might open an account in my name and debit this account one thousand dollars. On my books, however, there is no object in opening the second account.* If A. is credited on my books, the implication is that I am the debtor. The second account would give me no additional information. If money were the only thing by reason of which A. could be credited, and with which I could be charged, there would never be any object in opening the second account.*

* Except to put the books in balance.

Instead, however, of depositing one thousand dollars with me, A. might have delivered to me, for safe keeping, a valuable picture, worth one thousand dollars. Or, again, he may deposit with me one thousand dollars in money, and may also deliver to me, for safe keeping, a picture worth one thousand dollars. Where I may be charged with different things, there is an advantage in showing on my records with what I am charged. Therefore, after opening an account in the name of A., and crediting him one thousand dollars on account of the money, and one thousand dollars on account of the value of the picture, I open two additional accounts. One might be in my name with the additional statement that it was in the matter of (or related to) money. The other might be in my name with the additional statement that it was in the matter of the picture. It is unnecessary, however, to mention my name. It is sufficient, if I call the one account "Cash," and the other account "Picture." In the one case it is understood that the account stands for me in the matter of cash; in the other case it is understood that the account stands for me in the matter of the picture. The cash

account represents me, and the picture account represents me. The cash account I debit one thousand dollars, meaning that I am debited in the matter of cash. The picture account I debit one thousand dollars, meaning that I am debited in the matter of the picture.

A. owes B. five hundred dollars, and asks me to pay B. the five hundred dollars from the one thousand dollars that I hold for him, A. I therefore pay B. the five hundred dollars. As to this five hundred dollars, A., of course, is no longer my creditor. To show this, I enter five hundred dollars on the debit side of his account. This offsets his credit to that extent; or, to express it differently, and to give a new use to an old word, he is *discredited* to that extent. I wish to show on my records, also, that *I* am no longer charged with the five hundred dollars which I have paid by A.'s direction to B., and therefore I credit the account called "Cash," which represents me, five hundred dollars. This credit shows on my records that I am discharged, in the matter of cash, to the extent of the payment.

Again, suppose A. wishes to convert his picture into money, and requests me to sell

the picture for him. I sell the picture to C. for one thousand dollars. C. pays me the money, and I deliver to C. the picture. No longer am I charged with the picture. The account called "Picture" I therefore credit one thousand dollars, the sum for which I sold it. I am, however, responsible to A. for the one thousand dollars which I have received for the picture. Therefore I charge myself with this money, in the account called "Cash." The nature of my responsibility has changed. Whereas I was previously charged with a picture at its value of one thousand dollars, now I am charged with the cash for which it was sold. A. has been already credited with the value of the picture, and therefore it is not necessary to credit his account again. A.'s account shows a credit of fifteen hundred dollars, and the cash account shows a debit of fifteen hundred dollars.

A. wishes the money. Therefore I pay the fifteen hundred dollars to A., and debit his account, and credit the cash account, which represents me; and the transaction is closed.

In the above discussion the words "debtor" and "creditor" are used in their

accounting sense. In accounting, the terms "debtor" and "creditor" may express the legal relation of agent and principal, as well as the legal relation of debtor and creditor. From a legal point of view, it is possible, in the above *money* transactions, to regard A. as a principal and me as an agent, or A. as a creditor and me as a debtor. In both events, however, my accounts would be kept in the same way; except that, if the relation between A. and me is that of principal and agent, there might be a statement to that effect. Both in the matter of the money and in the matter of the picture, we will regard the legal relation as that of principal and agent.

Again, suppose E. delivers to me as his agent a thousand dollars, and authorizes me to borrow, on his behalf, a like sum of a third person. On my books, I, in the name of "Cash," am debited a thousand dollars, and E. is credited a thousand dollars. In the exercise of my authority, and on behalf of E., I borrow a thousand dollars of F. On account of this second transaction, I, in the name of "Cash," am debited a thousand dollars, and F. is credited a thousand dollars. The accounts that I have kept as agent

now show that I am debited two thousand dollars; that E., my principal, is credited a thousand dollars; and that F., a legal creditor, is credited a thousand dollars.

In all double-entry accounting, the accounts are kept as if there were a principal and an agent; although, at the same time, there, also, may be, with a third person, a relation of debtor and creditor. The principal is sometimes called the proprietor, and the agent the manager; and in mercantile transactions this is the common nomenclature.

The cash account and the picture account, in the above examples, are but illustrations of a large group of accounts called "property accounts" (or "real accounts"). Each of these property accounts, in theory at least, stands for a person, who acts as an agent, and is responsible to a principal for the property described in the name of the account. These accounts might be called agency or *managership* accounts.

There is no difference in theory between the cash account and other property accounts; except that cash, being a standard of value, is valued in terms of itself, while other property is valued, not in terms of

itself, but of cash. This difference in methods of valuation, however, does not affect the principle of debit and credit. Cash being also a medium of exchange, the cash account is put to certain uses that other property accounts are not.

A different class of accounts represents, not the agent, but the principal (or proprietor). In this class are the accounts called "Capital" and "Surplus;" the various "reserve accounts;" the account called "Profit and Loss;" and the various subsidiary profit and loss accounts — such as the "rent account," the "salary account," the miscellaneous expense account commonly called "Expense," the "services account," and the account (under whatever name) recording the differences between the prices at which goods are bought and the prices at which they are sold. By some writers on the subject, who have seen the true nature of the accounts in this class, they are called "proprietorship accounts." Any item charged or credited to any one of the accounts in this class could have been charged or credited directly to the proprietor under his own name. The subsidiary profit and loss accounts may, at first glance,

seem far removed from the proprietor; but the items charged or credited to these accounts might just as well, as far as the theory of accounting is concerned, be charged or credited directly to the proprietor. They are charged or credited, in the first place, to special accounts bearing impersonal names, simply to show, by means of classification, the sources of losses and gains. In so far as the debits exceed the credits, these accounts show sources of loss to the proprietor, and, in so far as the credits exceed the debits, they show sources of gain to the proprietor; but, whether they show losses or gains, the accounts represent the proprietor.*

Still a third class of accounts represents, not the agent (or manager), nor the principal (or proprietor), but third persons. The important account in this class is "Bills Payable." I buy one thousand bushels of wheat of M. at one dollar a bushel. I can pay M. one thousand dollars in cash; but,

* The term "nominal accounts" is frequently applied to the subsidiary profit and loss accounts; but, if the term is used at all, it might be well to extend its use to all proprietorship accounts that do not bear the name of the proprietor.

if it is not convenient for me at the time to pay him cash, and he is willing to extend credit to me for, say, thirty days, I open an account in his name on my books, and credit him one thousand dollars. It may be, however, that, although M. does not insist upon my paying him the money at the time of the transaction, he would like my obligation to pay him one thousand dollars to be in a more tangible form. Therefore I give him a note, in which I promise to pay him, or his order, one thousand dollars thirty days after date. In this event, I do not credit M. on my books, but I open an account called "Bills Payable," and I credit this account one thousand dollars. This account represents M.

A fourth class of accounts may be regarded as representing either the agent or a third person, but primarily represents the third person. The important account in this class is "Bills Receivable." I sell five hundred bushels of the wheat I bought from M. to N. at one dollar and twenty cents a bushel, and N. gives me his note, in which he promises to pay me, or my order, six hundred dollars thirty days after date. In this event, I do not open an

account in the name of N. and debit it, but I open an account called "Bills Receivable," and I debit this account. This account, called "Bills Receivable," represents N. But this account may also be regarded as representing the agent, because a bill receivable may be regarded as property. A bill receivable may be regarded as property either on account of its material character or because, in a sense, any debt, due from one person to another, is property of the person to whom it is due.

On the "Assets" (or debit) side of a balance sheet, sometimes appears an item described as "Discount on Bonds" (to be written off gradually). The amount of this item has been charged to a discount account, but, instead of being carried, at the end of the year (or other period), at once to the debit of "Profit and Loss," or directly to the debit of the proprietor, it is maintained on the books as a separate item, and placed in the balance sheet. This item, of course, represents the proprietor.

On the "Liabilities" (or credit) side of a balance sheet, is sometimes found an item described as "Accrued Depreciation." This item has been taken from a negative prop-

erty account, also called "Accrued Depreciation," which account is, in theory, only the credit side (in whole or in part) of a positive (or ordinary) property account. Instead of being credited to the negative property account, called "Accrued Depreciation," this item might have been credited directly to the positive property account. This item, of course, represents the manager. Depreciation, however, affects, not only the manager, but also the proprietor. At the same time that an account representing the manager is credited on account of the depreciation, an account representing the proprietor is debited on account of the same depreciation. The account representing the proprietor may be called "Profit and Loss," or "Depreciation," or any one of a large number of other names.*

* The item called in the text "Accrued Depreciation" (as well as the account from which it is taken) is usually called "Reserve for Accrued Depreciation" or "Reserve for Depreciation;" but an allowance for accrued depreciation (except so far as the allowance is excessive) is not a true reserve. A true reserve represents the proprietor, while an allowance for accrued depreciation (in so far as it is a credit) represents the manager. This item (and the account

One class of transactions requires an explanation; and that is, transactions with third persons. One thousand dollars is borrowed from a third person, whom we will call X. X. is credited one thousand dollars, and "Cash" is debited one thousand dollars. Strictly, X. should be credited one thousand dollars in his relation to the proprietor, and the proprietor should be debited one thousand dollars in his relation to X.; and then the proprietor should be credited one thousand dollars in his relation to the manager, and the manager, who is represented by "Cash," should be debited one thousand dollars in his relation to the proprietor. In order to record this double transaction, it would be necessary to have two accounts in the name of the proprietor

from which it is taken) might properly be called "Allowance for Accrued Depreciation" or "Allowance for Depreciation" or simply "Depreciation." However, if, instead of charging the depreciation directly to "Profit and Loss," a subsidiary profit and loss account should be opened and charged with the depreciation, this subsidiary profit and loss account would naturally be called "Depreciation;" and, of course, it would not do to have two accounts each called "Depreciation."

— one showing his relation to X. and the other his relation to the manager. But, by a fiction of accounting, there is a novation; X. accepts the obligation of the manager, represented by "Cash," and releases the proprietor, and, in consideration of the assumption by the manager of the obligation to X., the proprietor releases the manager. Of course, there is no such transaction, either in fact or in law; but accounting seeks to accomplish results with the least expenditure of time and energy, the proprietor's credit would be equal to his debit, and the fictional novation satisfies the practical requirements of the situation.

Again, a thousand dollars is lent to a third person, whom we will call Y. "Cash" is credited a thousand dollars, and Y. is debited a thousand dollars. Strictly, in this case, the manager, who is represented by "Cash," should be credited a thousand dollars in his relation to the proprietor, and the proprietor should be debited a thousand dollars in his relation to the manager; and then the proprietor should be credited a thousand dollars in his relation to Y., and Y. should be debited a thousand dollars in his relation to the proprietor. But, in this

case also, there is a fictional novation; the manager accepts the obligation of Y., and releases the proprietor, and, in consideration of the assumption by Y. of the obligation to the manager, the proprietor releases Y.

Whether the system of accounting is double-entry or not, the accounts are debited and credited in the same manner as if it were.

There are many impersonal accounts which I have not mentioned; but each one of them represents a person — the proprietor, the manager, or some third person. The so-called impersonal accounts are debited or credited because they represent persons.

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